

## Message Text

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ACTION EUR-12

INFO OCT-01 EA-07 ISO-00 SP-02 USIA-06 AID-05 EB-07 NSC-05

CIEP-01 SS-15 STR-04 OMB-01 CEA-01 CIAE-00 COME-00

FRB-03 INR-07 NSAE-00 XMB-02 OPIC-03 LAB-04 SIL-01

L-03 H-02 PA-01 PRS-01 /094 W

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R 192103Z NOV 76

FM AMEMBASSY LONDON

TO SECSTATE WASHDC 7938

TREASURY DEPT WASHDC

INFO AMEMBASSY PARIS

AMEMBASSY BONN

AMEMBASSY ROME

AMEMBASSY TOKYO

USMISSION OECD PARIS

USMISSION EC BRUSSELS

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C O R R E C T E D C O P Y (PARA "BEGIN SUMMARY:" LINE TWO)

E.O. 11652: N/A

TAGS: UK, EFIN

SUBJECT: NEW CREDIT RESTRICTIONS

BEGIN SUMMARY: THE BANK OF ENGLAND HAS REIMPOSED STRICT CONTROLS ON COMMERCIAL BANK CREDIT EXPANSION. THE CONTROLS ARE EXPECTED TO RESULT IN A LEVELING OFF IN BANK LENDING TO THE PRIVATE SECTOR WITH INDUSTRY GETTING PRIORITY ON AVAILABLE FUNDS AT THE EXPENSE OF CONSUMERS AND THE HOUSING SECTOR. IN ANNOUNCING THE NEW MEASURES THE CHANCELLOR FRANKLY ADMITTED THAT THEY WERE NECESSARY TO HOLD THE GROWTH OF THE MONEY SUPPLY (M3) WITHIN HIS STATED POLICY LIMIT OF 12 PERCENT FOR THE YEAR ENDING MARCH 31, 1977. END SUMMARY.

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1. IN A MOVE WHOSE ONLY SURPRISE CAME IN ITS TIMING ON NOVEMBER 18, THE BANK OF ENGLAND REVIVED A SYSTEM OF LIMITS ON BANK CREDIT EXPANSION KNOWN INFORMALLY AS THE CORSET. THE CORSET WAS ORIGINALLY CREATED BY THE HEATH GOVERNMENT IN 1973 TO STEM A RAPID INCREASE IN DOMESTIC CREDIT EXPANSION AND WAS LIFTED BY THE LABOR GOVERNMENT IN FEBRUARY 1975.

2. THE MECHANICS OF THE CORSET ARE STRAIGHTFORWARD. IT OPERATES BY DIRECTLY LIMITING THE RATE OF GROWTH OF INTEREST-BEARING ELIGIBLE LIABILITIES (IBELS). AN IBEL IS AN INTEREST-BEARING STERLING BANK DEPOSIT WITH A MATURITY OF LESS THAN TWO YEARS FOR A U.K. OR OVERSEAS RESIDENT, OR A DEPOSIT OF WHATEVER TERM ARISING AS A RESULT OF AN INTER-BANK TRANSACTION WITH THE DISCOUNT MARKET OR BY THE SALE OF A STERLING CERTIFICATE OF DEPOSIT. ABOUT TWO-THIRDS OF THE BANKS' ELIGIBLE LIABILITIES ARE INTEREST-BEARING.

3. UNDER THE RULES SET OUT IN THE NOVEMBER 18 ANNOUNCEMENT, BANKS WILL HAVE TO LIMIT THE RATE OF INCREASE OF THEIR IBELS OR FACE PROGRESSIVELY STIFFER PENALTIES IN THE FORM OF NON-INTEREST BEARING SUPPLEMENTARY DEPOSITS WITH THE BANK OF ENGLAND.

4. THE PENALTY FREE GROWTH RATE FOR IBELS IS 3 PERCENT BETWEEN THE AVERAGE AUGUST-OCTOBER BASE LEVEL AND THE AVERAGE FEBRUARY-APRIL LEVEL. SINCE THE AUGUST-OCTOBER AVERAGE LEVEL OF IBELS WAS 24.531 BILLION POUNDS, THE CORSET LIMITS THE PENALTY FREE FEBRUARY-APRIL AVERAGE TO 25.267 BILLION POUNDS. BEYOND THE FEBRUARY-APRIL PERIOD, THE PENALTY FREE GROWTH INCREASES BY A FURTHER 0.5 PERCENT A MONTH IN MAY AND IN JUNE. FOR EXAMPLE, ANY IBELS IN EXCESS OF 25.267 BILLION POUNDS DURING THE FEBRUARY-APRIL PERIOD WILL BE SUBJECT TO THE FOLLOWING (EMBASSY ESTIMATED) PENALTY SCHEDULE:

AVERAGE FEB-APR. IBELS LEVEL	MARGINAL PENALTY RATE	REQUIRED SUPPLEMENTARY DEPOSITS
GROWTH RATE (PERCENT)	(MILLIONS OF POUNDS)	(MILLIONS OF POUNDS)

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7	262.48	25	61.5
8	264.93	25	61.5
9	267.39	50	123.0

AND BEYOND. FOR EXAMPLE, IF A BANK, WHOSE AVERAGE AUG-

UST-OCTOBER IBELS WAS 100 MILLION POUNDS, INCREASED THAT AVERAGE TO 109 MILLION DURING THE FEBRUARY-APRIL PERIOD, NEXT MAY IT WOULD HAVE TO MAKE A SUPPLEMENTARY DEPOSIT BEARING NO INTEREST OF 1.15 MILLION POUNDS WITH THE BANK OF ENGLAND. THIS FIGURE REPRESENTS THE CUMULATIVE PENALTIES ON THE 6 MILLION POUNDS OF EXCESS IBELS GROWTH BEYOND THE PERMITTED 3 PERCENT. FOR SUCH A BANK, THE EFFECTIVE PENALTY WOULD BE 19.2 PERCENT OF THE EXCESS GROWTH

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IN ITS IBELS. AS THE GROWTH PROCEEDS BEYOND 9 PERCENT THE EFFECTIVE PENALTY RATE APPROACHES 50 PERCENT.

5. SINCE THE LEVEL OF IBELS IN OCTOBER WAS 25.218 BILLION POUNDS, VIRTUALLY 2.8 OF THE 3.0 PERCENT GROWTH RATE

HAS ALREADY OCCURRED. THIS MEANS THAT THE RATE OF GROWTH IN IBELS MUST REMAIN ABOUT FLAT OVER THE COMING MONTHS IF BANKS AS A GROUP ARE TO AVOID MAKING SUPPLEMENTARY DEPOSITS IN MAY. IN PRACTICAL TERMS, THE CORSET MAKES IT INCREASINGLY COSTLY FOR THE BANKS TO BUY IN THE WHOLESALE MONEY MARKET IN ORDER TO RELEND TO RETAIL CUSTOMERS. WHY HAS HMG CHOSEN TO IMPOSE SUCH SEVERE RESTRICTIONS ON THE BANKING SYSTEM?

6. THE IMMEDIATE EXPLANATION IS A DISAPPOINTINGLY HIGH RATE OF M3 GROWTH IN OCTOBER. AFTER INCREASING ITS MINI-LIMITED OFFICIAL USE

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MUM LENDING RATE TO 15 PERCENT EARLY IN OCTOBER, THE BANK OF ENGLAND EXPECTED THAT INCREASED SALES OF GILTS WOULD BRING ABOUT A SHARP DECLINE IN THE RATE OF GROWTH OF M3. THIS HAS NOT OCCURRED. THERE ARE INDICATIONS THAT IN OCTOBER M3 GROWTH, WHILE SLOWER THAN THE SEPTEMBER RATE OF 2.4 PERCENT WAS STILL ABOVE 1 PERCENT. THIS MADE IT CRYSTAL CLEAR THAT EVEN MORE STRINGENT MEASURES WOULD BE NEEDED TO KEEP M3 GROWTH WITHIN THE CHANCELLOR'S 12 PER-CENT GROWTH RATE FOR THE FISCAL YEAR ENDING MARCH 31, 1977. THE CORSET WAS AN OBVIOUS MEANS OF DRASTICALLY REDUCING BANK LENDING TO THE PRIVATE SECTOR, A PRIME FAC-TOR BEHIND M3 GROWTH.

7. ECONOMIC IMPACT. A MONETARY POLICY WHICH HAD BEGUN TO LOOK ACCOMMODATING DURING THE SUMMER MONTHS HAS NOW BEEN MADE SHARPLY RESTRICTIVE. OVER THE FIRST SEVEN MONTHS OF THE CURRENT FISCAL YEAR M3 GREW AT AN ANNUAL RATE OF ABOUT 16.5 PERCENT. THUS M3 CAN ONLY GROW AT AN ANNUAL RATE OF ABOUT 5.5 PERCENT OVER THE NEXT FIVE MONTHS FOR THE 12 PERCENT TARGET TO BE REACHED. THE CORSET MIGHT JUST PERMIT THIS TO BE DONE. BUT MOST LIKELY AT THE COST OF ANY FURTHER NET INCREASE IN BORROWING BY THE PRIVATE SECTOR. THIS IS NOT TO IMPLY THAT ALL BANK LENDING TO PRIVATE SECTOR BORROWERS WILL CEASE, BUT RATHER THAT A SYSTEM OF PRIORITIES WILL BE ESTABLISHED TO SEPARATE DIFFERENT GROUPS OF PRIVATE BORROWERS WITH CON-SUMERS AND HOME BUYERS LIKELY TO BE AT THE BOTTOM OF THE LIST AND EXPORTERS AND INDUSTRIAL BORROWERS AT THE TOP.

POTENTIAL SOURCES OF FUNDS SUCH AS INSURANCE COMPANIES, PENSION FUNDS AND SOME CORPORATE LENDERS WILL FIND THAT BANKS ARE NO LONGER BIDDING ACTIVELY FOR THEIR RESOURCES AND THUS HAVE TO TURN TO GOVERNMENT INSTRUMENTS THEREBY EASING PRESSURE ON M3.

THE INFLOW OF STERLING CAUSED BY THE END OF LENDING TO FINANCE THIRD COUNTRY TRADE (SEE SEPTEL) MAY ADD 300 - 500 MILLION POUNDS TO THE 1.47 BILLION POUNDS REPRESENTED BY THE 3 PERCENT GROWTH RATE, THUS SOMEWHAT EASING ITS

IMPACT. HOWEVER, IT WILL CAUSE A FURTHER WEAKENING IN CONSUMER BORROWING.

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## Message Attributes

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